

# Lecture 1

## Financial system: overview

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**EE431 Semester 2/2016**

# Agenda

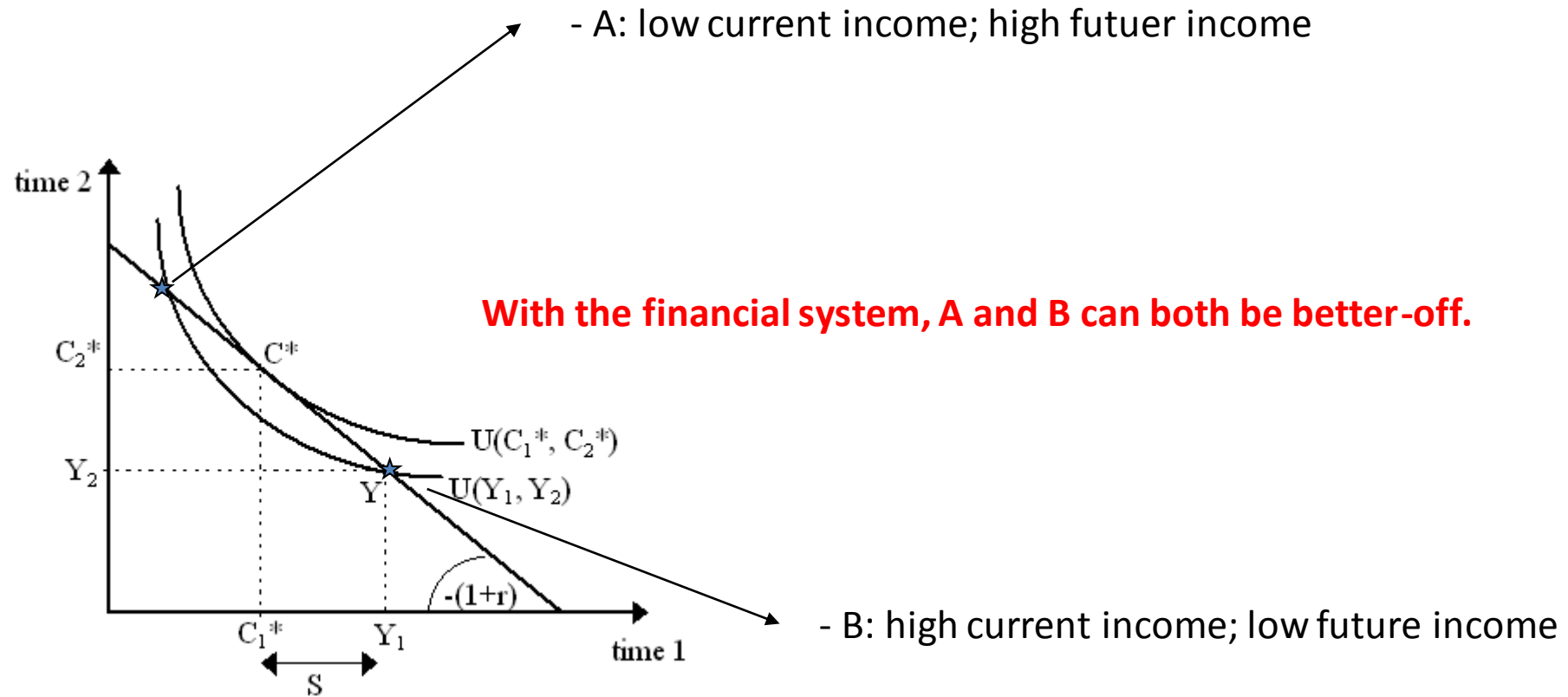
What does financial system do?

- Structure of financial system

# What does financial system do?

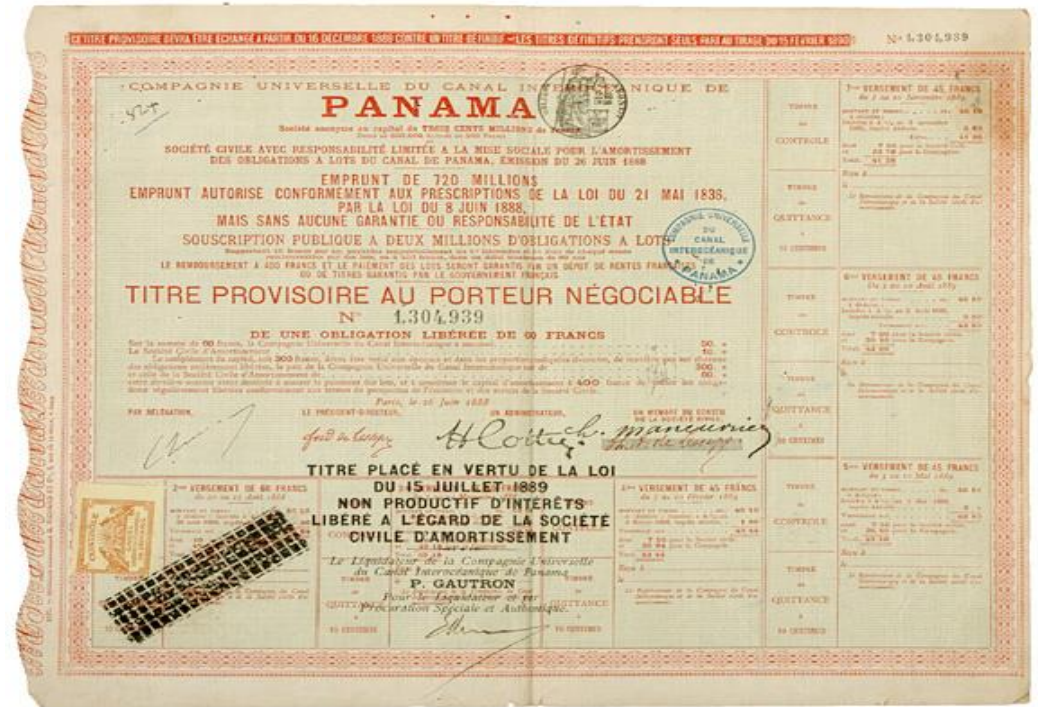
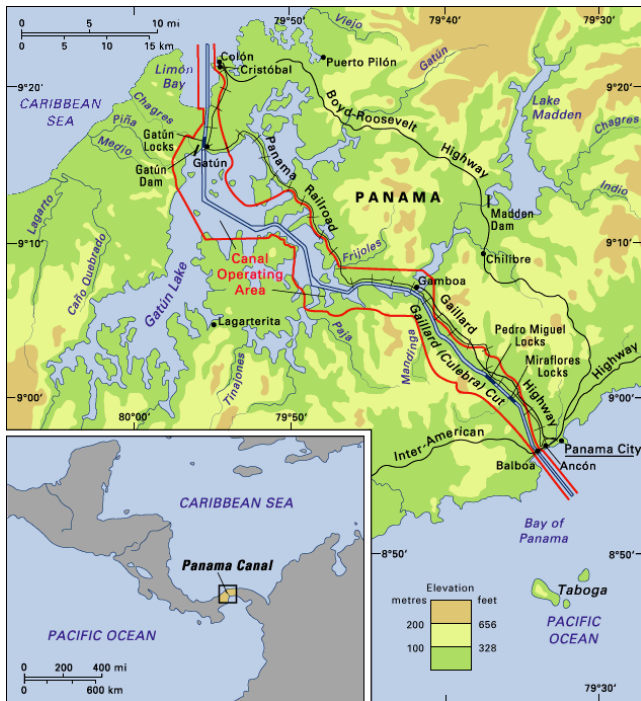
- Channel funds between **Deficit units** and **Surplus units**
  - Better timing spending stream
  - Enhance the efficient use of capital: promote economic growth

# win-win: better consumption timing



# Panama Canal

In 2004 dollars, adjusted with the U.S. GDP deflator, the Panama Canal cost \$4.4 billion.



# Basic Global Social Savings Estimates (by route, in millions of 1925 dollars)

	Panama Canal route	Shortest alternative
<i>Selected U.S. routes</i>		
New York to Valparaíso	5,515	8,512
New York to Los Angeles	5,812	12,949
New York to Portland	6,756	13,907
New York to Vancouver	6,925	14,054
San Francisco to Liverpool	7,825	13,841
New York to Sydney	10,573	12,762
New York to Shanghai	11,471	16,746
<i>Selected non-U.S. routes</i>		
Tampico to Valparaíso	4,785	9,088
Liverpool to Valparaíso	7,192	11,841
Liverpool to Vancouver	8,602	13,251
Liverpool to Sydney	12,250	11,514
Liverpool to Shanghai	13,148	10,465

Source: [www.distances.com](http://www.distances.com)

# Shorten the distance; cost-saving

	Panama Canal route	Shortest alternative		1921	1922	1923	1924	1925	1926	1927	1928	1929
<i>Selected U.S. routes</i>			US Intercontinental									
New York to Valparaíso	5,515	8,512	US East - SouthAm West	\$3.78	\$1.57	\$3.73	\$4.70	\$5.70	\$6.37	\$5.72	\$5.35	\$4.73
New York to Los Angeles	5,812	12,949	US East - Asia	\$5.73	\$7.09	\$6.10	\$5.51	\$4.95	\$6.07	\$6.81	\$6.04	\$6.23
New York to Portland	6,756	13,907	US East - Australasia	\$1.11	\$0.48	\$0.71	\$0.81	\$0.95	\$1.09	\$1.18	\$0.78	\$0.67
New York to Vancouver	6,925	14,054	US West - Europe	\$5.17	\$5.92	\$5.09	\$5.79	\$5.62	\$6.53	\$7.92	\$7.82	\$7.93
San Francisco to Liverpool	7,825	13,841	Non-US intercontinental									
New York to Sydney	10,573	12,762	Europe-Canada West	\$0.00	\$1.75	\$3.14	\$3.92	\$5.15	\$6.28	\$7.45	\$9.46	\$6.75
New York to Shanghai	11,471	16,746	Europe to SouthAm West	\$3.75	\$2.91	\$4.93	\$5.41	\$7.23	\$7.30	\$5.90	\$7.49	\$7.03
<i>Selected non-U.S. routes</i>			Mexico East to SouthAm West	\$1.86	\$0.73	\$0.67	\$0.65	\$0.32	\$0.00	\$0.00	\$0.00	\$0.00
Tampico to Valparaíso	4,785	9,088	Transcontinental	\$10.80	\$23.76	\$78.27	\$128.42	\$84.57	\$96.16	\$99.49	\$96.89	\$106.26
Liverpool to Valparaíso	7,192	11,841	Minus tolls	(6.22)	(11.56)	(17.60)	(24.72)	(21.37)	(22.82)	(24.69)	(27.27)	(27.36)
Liverpool to Vancouver	8,602	13,251	TOTAL	\$25.99	\$32.66	\$85.05	\$130.49	\$93.10	\$106.98	\$109.79	\$106.56	\$112.24
Liverpool to Sydney	12,250	11,514										
Liverpool to Shanghai	13,148	10,465										
Source: <a href="http://www.distances.com">www.distances.com</a>			Social rate of return	2.8%	3.5%	9.2%	14.2%	10.1%	11.6%	11.9%	11.6%	12.2%

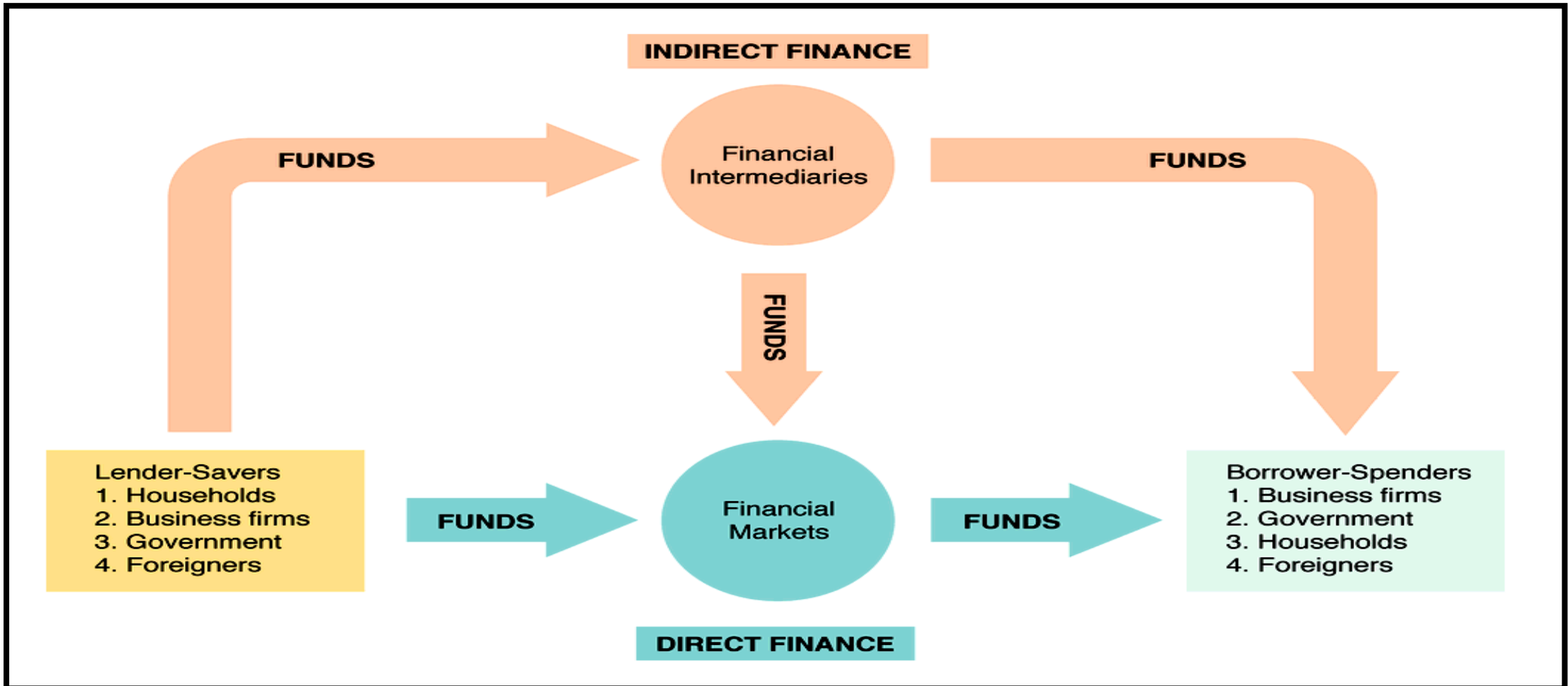
# Other functions

- Risk-bearing/Risk-sharing process:
  - Insurance products
  - Hedge instruments
- Facilitate the payment system
  - Bank branching system

# Agenda

- What does financial system do?
- Structure of financial system

# Structure of financial system



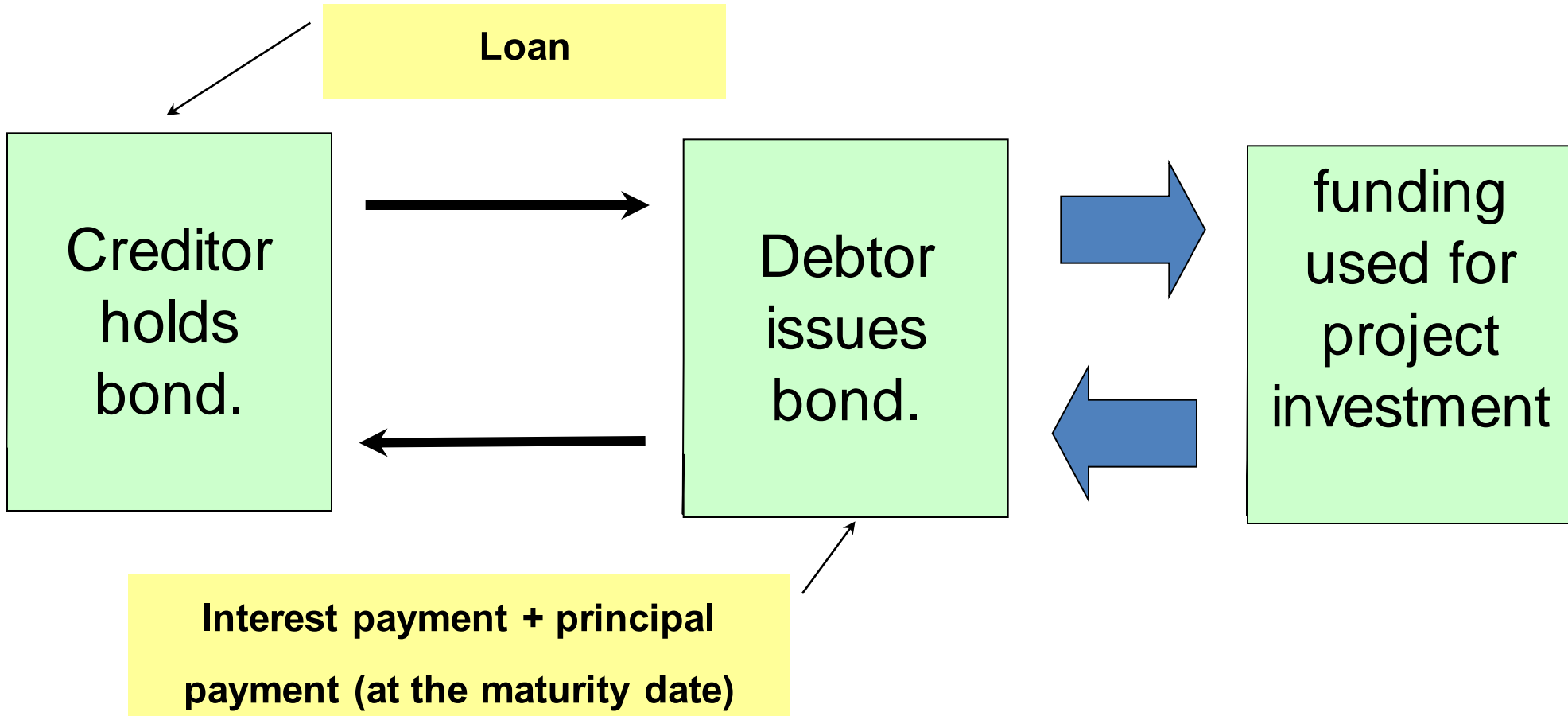
# Direct finance

- Types of financial products
- Types of markets

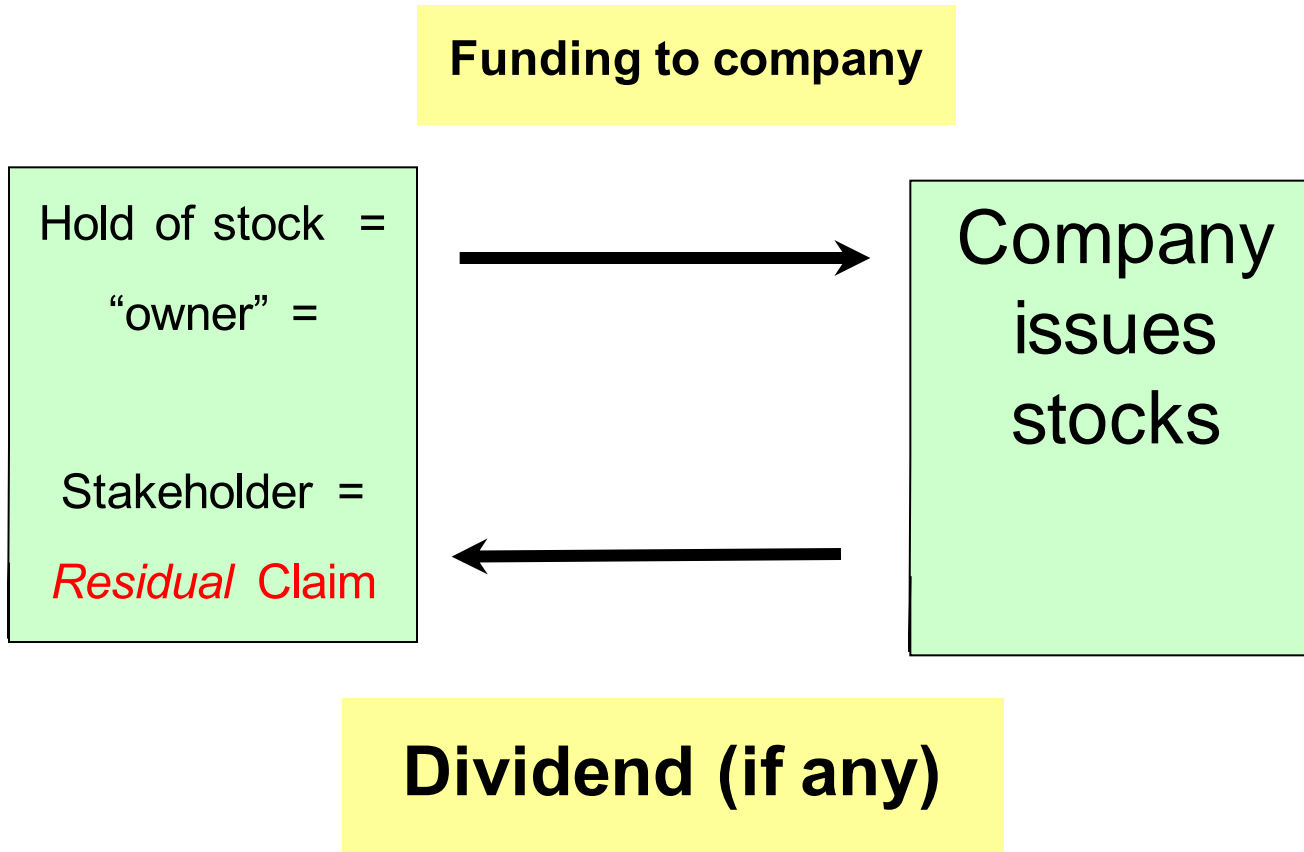
# Types of financial products

- Debt instrument
- Equity instrument
- Derivative instrument

# (Debt Instrument) : BOND



# (Equity Instrument) : STOCK



# Derivative instrument

- For the purpose of risk management
- Future? Option? CDS?

# Types of financial markets

- Linkages between Issuers and Holders
  - Primary market
  - Secondary market
- Maturity date
  - Money market
  - Capital market

# Primary v.s. Secondary

- **Primary market:** cash transacted in this market will be allocated to the fund raiser who issues the instrument.
- **Secondary market:** trading/resell the instrument for cash.
  - Organized Exchange
  - Over The Counter (OTC)

# Organized exchange market

- SET, TFEX, TBX, NYSE, NASDAQ, Nikkei .....
- “middleman” = broker
- Buying/selling order will be processed at a central location; with an organized platform of exchange
- Clear rule: minimum margins, payment period
- Single market price!!!

# Over the counter

- OTC is commonly used in bond/derivative/foreign currency trading.
- Broker-dealer helps facilitating the trading process
  - Dealer v.s. Broker?
- Bilateral trading → quoted prices could be varied; takes some times before all the prices converge, if any.
  
- Digression: “middleman” is important → why dealer not broker in some markets, and why broker in some markets.

# Money and capital market

- Duration of financial contract: maturity date
  - Money Market:  $< 1$  year
  - Capital Market:  $> 1$  year

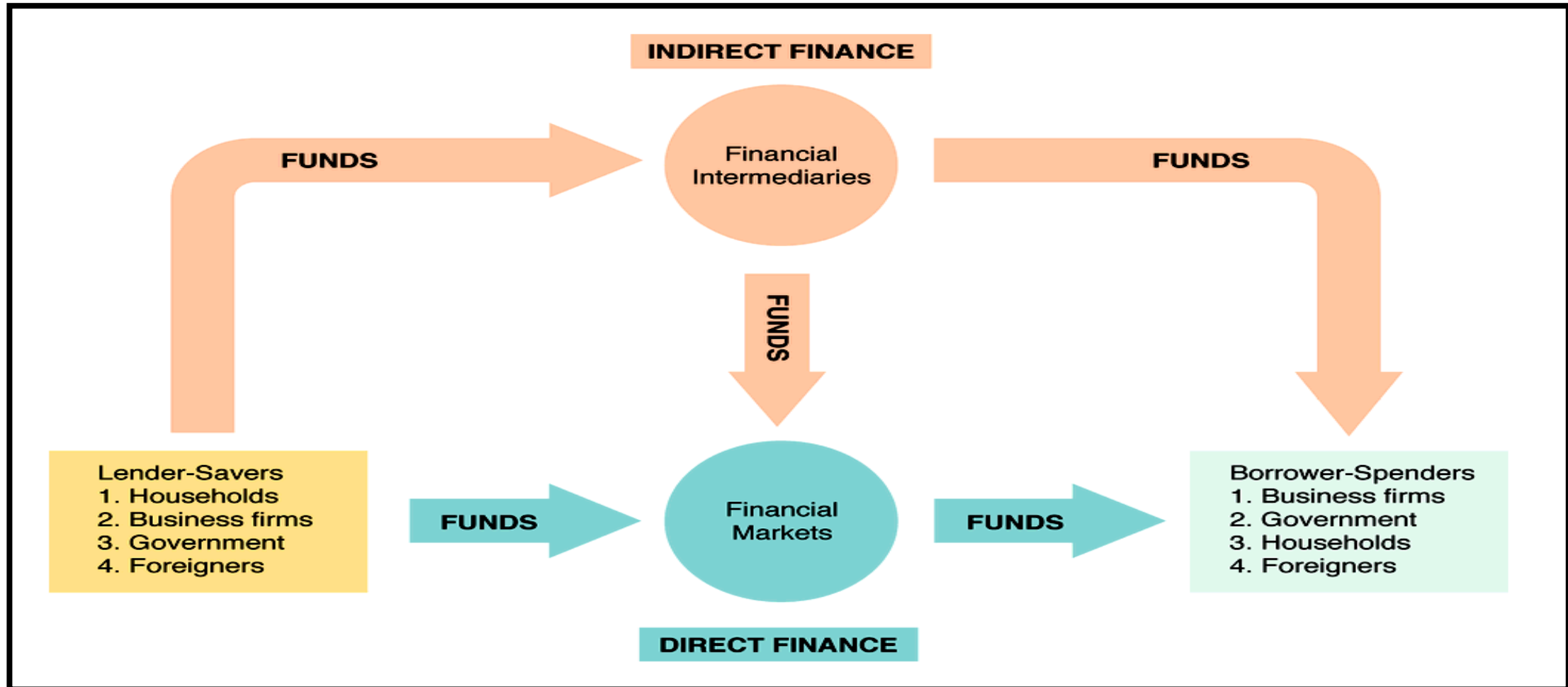
# Government

# Corporate

- Treasury Bill
- Government Bond
- State-Owned Enterprise Bond
- Bank of Thailand bond
- Financial Institutions Development: FIDF bond)

- Bill of exchange (BE)
- Corporate Bond (Debenture)
- Secured v.s. Non-Secured Debt
- Senior-Debt
- Subordinated Debt
- Hybrid Debenture
- Residential mortgage-backed security

# Structure of financial system: Financial intermediaries



# Financial intermediaries (FIs)

- Intermediary helps facilitating the transaction between Surplus units and Deficit units, aka indirect financing
- Some groups of market participants might be facing “some difficulties” for, and make their direct entrance to the financial markets as an unprofitable option.
  - Transaction cost associated with financial transaction.
  - Cost associated with mitigating the asymmetric information problem
- FIs overcome (alleviate) these difficulties, and enhance the efficiency of financial system as a whole, i.e. allowing greater pool of people to access to financial services.

# Types of financial institutions (1/4)

- Depository Institutions
  - Commercial Banks and Credit union
  - Take the deposit and originate loan to non-financial firms, households and government (other financial firms too.)
  - Deposit v.s. Other forms of debt contract?
  - Prone to run, highly regulated!!!

# Types of financial institutions (2/4)

- Contractual Saving Company
  - *Contractual* (periodic) Payment
  - E.g: Life-insruance, provident funds, retirement funds

# Types of financial institutions (3/4)

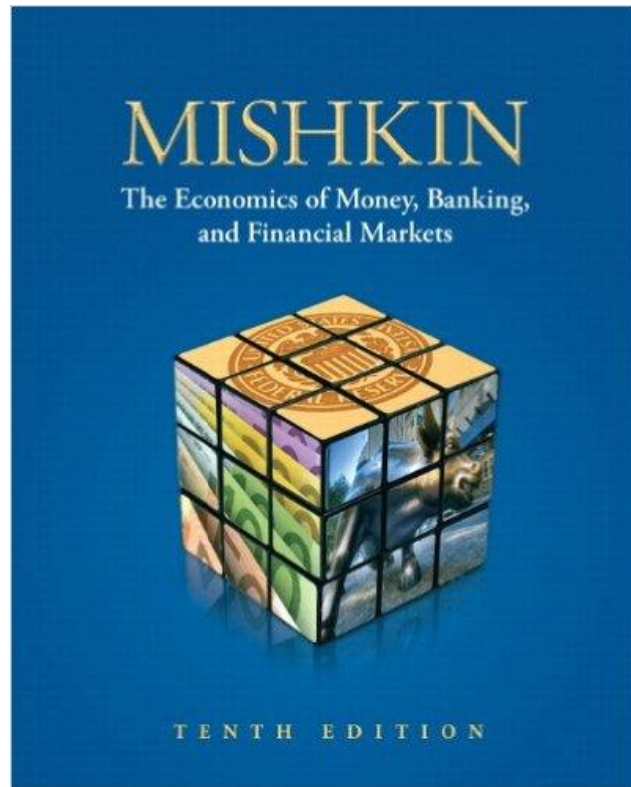
- *Security* Market Institution
  - Business related to market security.
  - E.g. Investment Bank, Mutual Funds, Brokerage Firm and Organized Exchange Market

# Types of financial institutions (4/4)

- Government sponsored enterprise (GSE)
  - Serve for some particular objectives set by the government
  - E.g. Government Saving bank; Government housing bank; SMEs bank, Agricultural bank etc.

# Readings

## Chapter 1 – 3: Mishkin



## Chapter 1 – 3: Prof.Anya

